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SUMMARY

¶1. (SBU) Russia's initial public offering (IPO) bonanza continued to gain momentum in 2006. Fifteen Russian companies launched IPOs this year, raising over $17.5 billion. At the same time, Russia's domestic exchanges have enjoyed explosive growth. Russian companies are increasingly able to tap the domestic markets for cash, as relaxed listing standards and increased liquidity have made Russian exchanges attractive IPO venues. Though motivations vary, many in the evolving IPO arena seem focused simply on raising investment capital. To get to the money, Russian companies have had to increase transparency and improve corporate governance to meet foreign and domestic listing requirements. Indeed, public offerings appear to be playing a significant role in transforming Russian business practices and creating a robust domestic equities market.

RUSSIA'S IPO BOOM KEEPS BOOMING

¶2. (SBU) The Russian IPO market has reached new heights this year, easily eclipsing the $5 billion raised in 2005 (reftel). By the end of 2006, Russia will have the largest single stock in the emerging-market universe (Gazprom), will have placed the fifth-largest IPO in history (Rosneft), and will have raised through equity issuance more money in 2006 than every country in the world except the U.S., China, and France. And some predict 30-40 more Russian IPOs in the coming year, bringing another $30 billion worth of equity to the market.

¶3. (SBU) As was the case in 2005, the London Stock Exchange (LSE) was the foreign exchange of choice for Russian companies looking to list abroad, as most see U.S. standards as too high and too costly. More than half of this year's Russian IPO activity included listings on the LSE. However, unlike last year, Russian companies also came to the Moscow Interbank Currency Exchange (MICEX) and the Russian Trading System (RTS) to raise capital, with six Russian IPOs occurred exclusively on the domestic exchanges. Indeed, one of the biggest shifts over the year has been the increase in the number of Russian companies looking to raise capital at home.

¶4. (C) The head of Russia's Federal Service for Financial Markets (FFMS), Oleg Vyugin, can take much of the credit for

encouraging growth in the domestic exchanges. Vyugin has simplified the procedure by which companies launch IPOs on the Russian markets. In fact, he claimed recently to us that it is now easier to launch an IPO in Russia than it is to do so in London. Vyugin also spearheaded a 30% domestic-listing requirement earlier this year, but he is slow to celebrate the success of this initiative. He suspects that brokerages operating in Russia have been taking ordinary shares on their books, and then sending these same shares abroad. A deeper analysis, which is currently underway, should reveal whether Russian capital is staying close to home. Whatever the result, the impressive growth of Russia's domestic exchanges is hard to ignore. The MICEX and the RTS now have a combined market capitalization of almost $800 billion, or 80% of GDP. Trading on the MICEX grew by 191% over 2005, while the RTS grew by 122%. Around 70% of Russian stock trading now occurs on the domestic exchanges, up from 55% one year ago. Without a doubt, the stereotype of a cash-poor Russian equity market is crumbling.

NEED FOR CAPITAL IS THE MAIN,
BUT NOT SOLE, DRIVER

¶5. (SBU) Russia's economy continues to chug along. Real GDP looks to be coming in just below 7% in 2006. Russia's money supply has increased by 40% this year, yet its inflation rate (though still high) will be below 10%. Both public and private consumption have grown over the year, as Russians continue to make more money and take out more consumer loans. Capitalizing on new market opportunities has been a challenge for Russian firms, as many still suffer from underinvestment. It comes as no surprise that demand for investment capital is high. Russian companies have turned to

IPOs to raise the money they need for growth in an increasingly competitive market.

¶6. (C) Of course, the need for investment capital is not the only force driving IPOs. As in 2005, some strategic shareholders have looked to IPOs as a way of "cashing out" of their holdings. Doing so has helped them capture immediate, and often tremendous, wealth. However, our contacts have been quick to downplay the significance of the "cash-out" incentive in 2006. They argue that strategic shareholders stand to gain much more from staying with their lucrative businesses than they do from cashing out of them.

¶7. (C) Oleg Vyugin echoed this sentiment in our recent conversations with him. He believes raising capital for company growth is the main target of recent IPOs. Vyugin also described an additional role IPOs have assumed in corporate strategy: enhancing management capacity. "As a company grows, it becomes more difficult for management to handle the size of the company." By increasing the shareholder base, new people are attracted to help manage the firm. In some cases, these people are industry elites with superlative reputations. Company boards have been increased to include managers championing Western-style business practices. With new management, Russian companies are coming to realize that efficiency, increased accountability, and improved corporate governance are essential to success in today's global market. And, he adds, strategic investors (many of whom are founding oligarchs) have their hands freed to pursue other interests.

¶8. (SBU) Naturally, companies have been improving business practices to the extent there is incentive to do so. Standard & Poor's Julia Kochetygova told us that she thought listing requirements are shaping changes in transparency and corporate governance -- for the better. For Russian companies looking to list abroad, this normally means adopting standards sufficient for listing with the LSE. Similarly, in an effort to attract investors, Russia's domestic exchanges have increased accountability standards

for companies looking to list in Russia. Firms trading on the MICEX and the RTS now boast transparency and corporate governance levels that meet international standards. Kochetygova's work shows that most publicly-traded Russian firms exceed the listing requirements of LSE's AIM market.

WHO'S BUYING?

¶9. (SBU) Improvements in macroeconomic conditions and increased accountability have encouraged global investors to boost exposure to the Russian markets. In the wake of the elimination of the so-called "Gazprom ringfence," emerging market indexes have been substantially rebalanced this year. The Morgan Stanley Capital International (MSCI) emerging markets index, widely considered the industry benchmark, has been reconstituted in 2006 to increase its Russia composition from 6% in 2005 to 11%. The upshot of this is that foreign investment in Russian equities, once dominated by short-term speculators, now comprises more long-term investors. Large international investment houses, such as Morgan Stanley, Merrill Lynch, and Citigroup, have come to Russia.

¶10. (SBU) Russia's domestic exchanges have also enjoyed investment from local institutions. Mutual funds, pension funds, and insurance companies constitute the bulk of home-grown interest. In fact, Russia's mutual fund industry has grown from virtually non-existent just a few years ago to a $15 billion industry today. Even so, the domestic markets have been slow to attract individual investors. Less than 3% of the Russian population own stock or other investment instruments. Nevertheless, there are signs that a domestic investor base is forming. Our MICEX contacts are confident that middle-class Russians will come to the markets as they become better informed and more investment savvy.

MUSINGS OF A MARKET REGULATOR

¶11. (C) In an early December meeting with us, Vyugin said he is considering abandoning the 30% domestic-listing requirement. In its place, he would oblige Russian companies to launch IPOs on a domestic exchange -- with at least 10% of the capital of ordinary shares in Russia -- before listing abroad. This policy change could gain momentum in the coming year. Vyugin has also made some progress on a few of his

long-term do-list items. A draft law addressing price manipulation and insider trading (first proposed two years ago) is now with the Central Bank, the Ministry of Finance, and the Ministry of Economic Development and Trade for final comment, although Vyugin believes he has already secured their basic agreement. The draft needs to go through a formal signature process, after which it will go to the Ministry of Justice for a final check before submission to the Government, which he hoped would result in approval by the end of this year. In addition, a draft law creating a Central Depository was finalized in August. The Central Depository would absorb the existing depository firms -- a move which could receive resistance from those with an economic interest in the status quo. A hardy perennial for ten years, Vyugin hopes remaining disagreements over the draft law will be resolved by the end of the year.

COMMANDING HEIGHTS STILL
COMMAND THE MOST MONEY

¶12. (SBU) As prices for oil, nickel, aluminum, platinum, and copper reached new highs this year, Russia's state-controlled companies benefited most on the bourses. Russia's energy and steel sectors still constitute the largest portion of the shares traded on the domestic exchanges, and foreigners continue to invest mostly in these sectors. However, Russia's diversifying economy is also producing attractive

investments in other sectors, particularly in banking, communications, and retail, where sectors which were well-represented in this year's IPOs. Russia's largest domestic-only listing was retail giant Magnit, whose revenues exceeded $1 billion in the first six months of 2006. Next year looks equally promising, as some predict as many as 15 retail-related companies will launch IPOs.

COMMENT

¶13. (C) As Russian companies look to raise capital and gain prestige, the requirements for them to do so are slowly transforming Russian business practices. And there's a sense that the new wave of business executives coming to Russian industry will serve as iconoclasts to the current paradigm of opacity and inefficiency. More and more, Russian companies are recognizing that entry into the global business world cannot happen without transparency. Even Russia's state-controlled companies have taken notice. This is not to say that companies under state control don't still have a lot to learn. As Oleg Vyugin put it, "an imitation of good corporate governance" won't make a company competitive. Recent troubles at Gazprom illustrate this fact: either you become efficient, or your stock price will freeze.

¶14. (C) Russia's domestic exchanges will continue to grow in ¶2007. Thus far, they have been able to produce surprisingly impressive trading numbers with relatively few issuers. This year we saw signs of a virtuous circle that we believe has not quite run its course: with new listings come new investors and added liquidity, which will likely lure yet more to the IPO table. To the extent this also forces transparency and compliance with international norms and market expectations, it is one of the most visible signs of grass-roots economic reform in Russia. The real test will come when global and domestic liquidity tightens, and the fight to keep shareholders happy sharpens.
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